

CAN STRUCTURAL
MEASURES SOLVE THE TOO-
IMPORTANT-TO-FAIL
PROBLEM?

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Dealing with Too-Important-To Fail Problem

Two broad approaches:

- ▣ price-based regulations, enhanced supervision and effective resolution; and
- ▣ structural limits on the size and scope of the activities of these institutions.

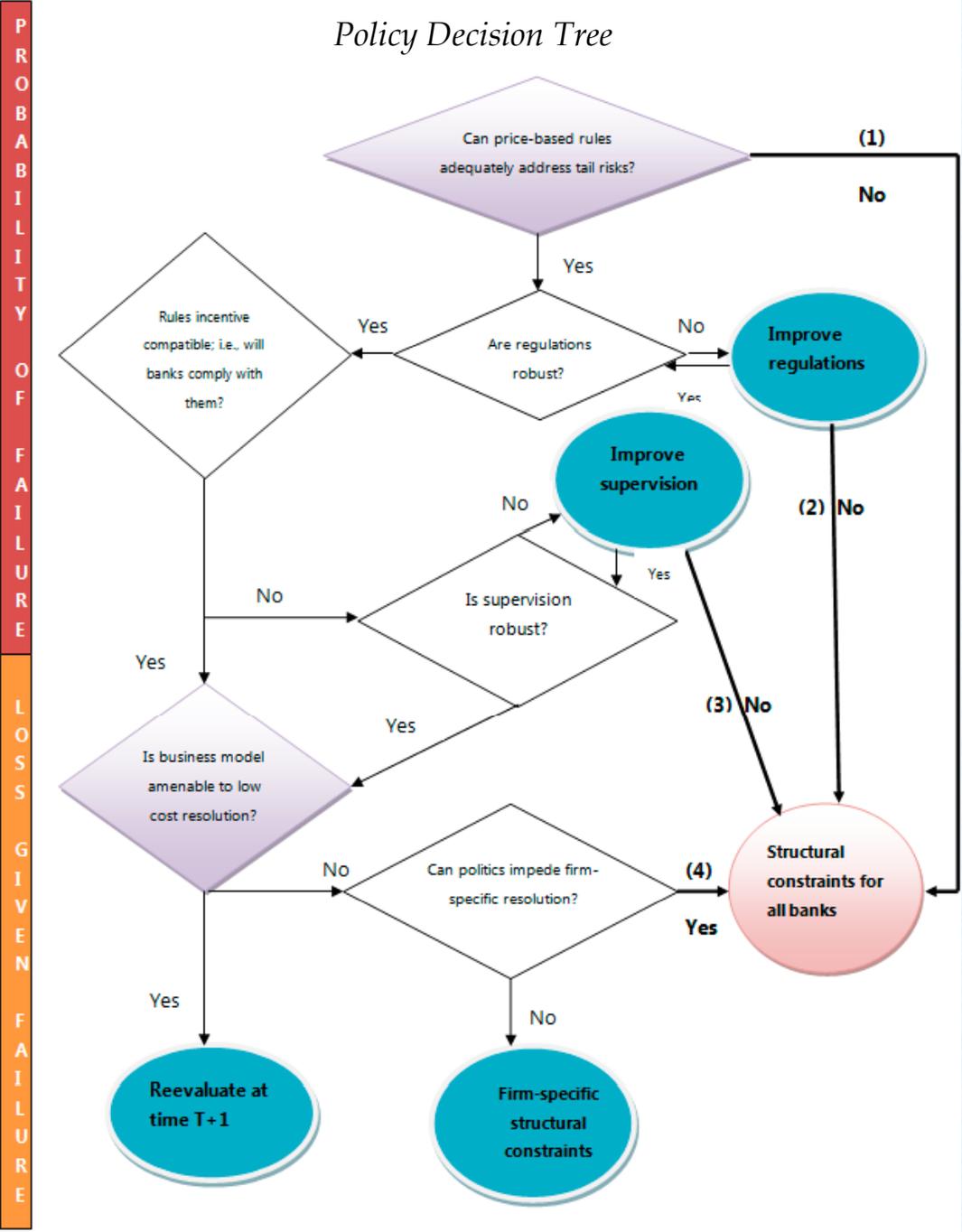
Global Regulatory Reform Agenda

- ▣ Enhanced regulatory framework
- ▣ Proactive and intensive supervision
- ▣ An effective resolution framework, including bail-in and *firm-specific* structural measures
- ▣ Enhanced transparency and disclosure
- ▣ Strengthened market infrastructure

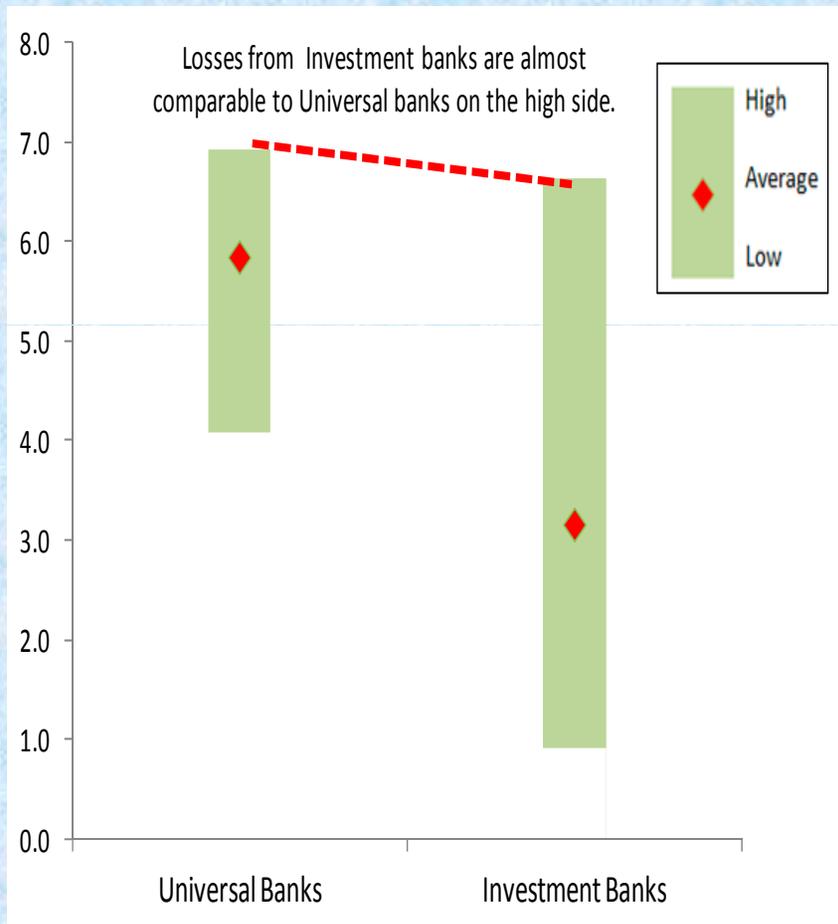
Structural measures to combat systemic risk

- ▣ Proposals range from:
 - moving businesses identified as too risky and complex into stand-alone subsidiaries
 - prohibiting banks from engaging in these activities altogether
- ▣ The US, UK, EU and other proposals support the global reform agenda.
- ▣ But also presume that they are *not sufficient* and *may not be implemented in a consistent manner*.
- ▣ Proponents of structural measures argue for a belt-and-braces approach.

Policy Decision Tree

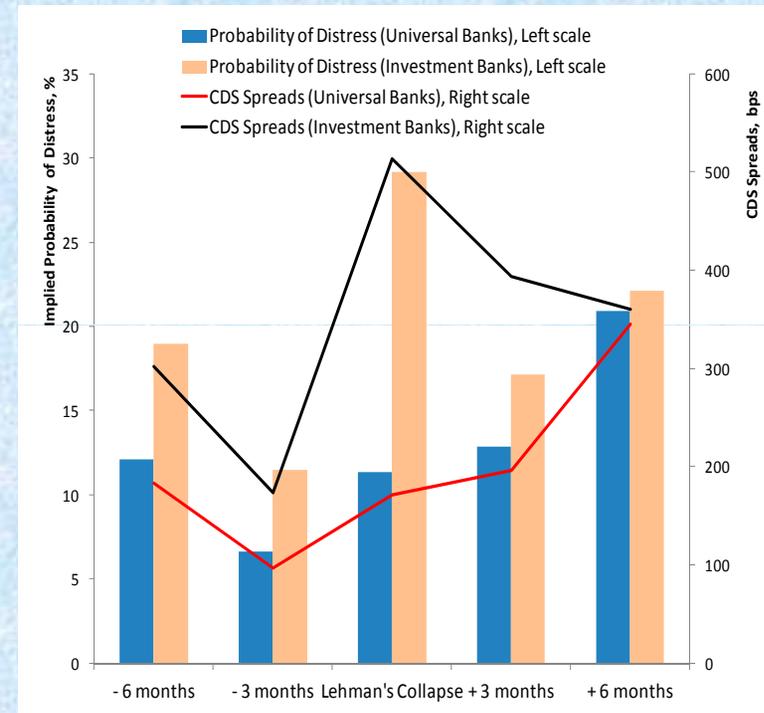


Do business models matter?



Source: Bloomberg, Staff estimates

Note: Green bars represent the range of bank losses.



Source: Bloomberg, Staff estimates

1. Sample U.S. banks comprise Citigroup, Bank of America and JP Morgan Chase (Universal Banks), and Morgan Stanley, Goldman Sachs, Lehman and Merrill Lynch (Investment Banks). Implied probability of distress is computed from the 5-year CDS spreads assuming a recovery rate of 30 percent.

Proposals

US Volcker Rule' – *outright separation* of businesses

European proposals require *subsidiarization* and restricting intra-group exposures

- ▣ US Volcker rule mandates separation of prop trading and hedge fund/private equity investments.
- ▣ UK retail ring-fence pushes most investment banking outside UK ring-fenced deposit taking banks.
- ▣ The EU (Liikanen group) prohibits market making, prop trading and hedge fund/private equity investments by the deposit taking entity.

Potential benefits

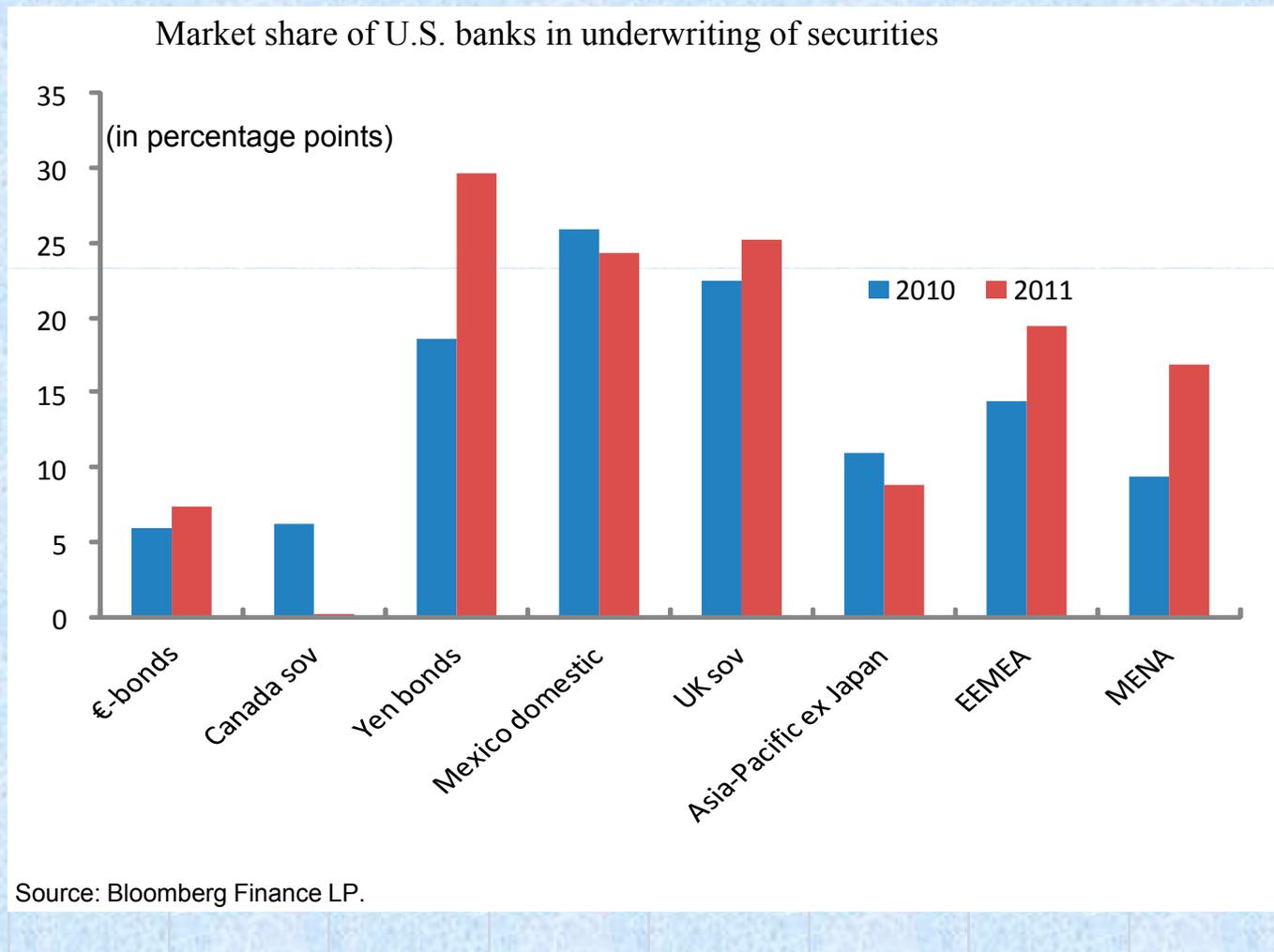
- ▣ **Risk reduction**
 - reducing complexity
 - reducing interconnectedness

- ▣ **Facilitate resolvability**
 - of the deposit entity but group level?

Potential costs

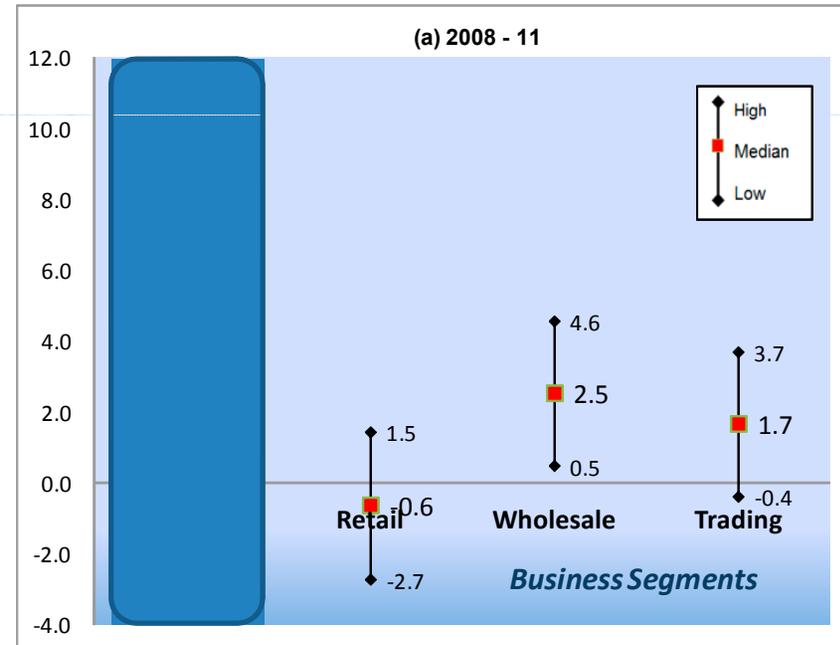
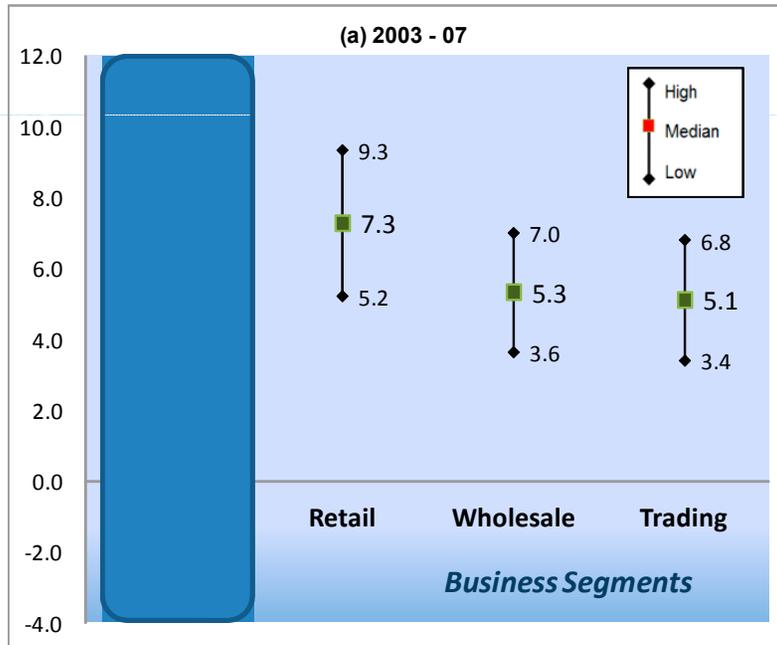
- ▣ **Implementation challenges.** How are supervisors to consistently and correctly identify the intent behind bankers' trades?
- ▣ Enhanced home-host supervisory collaboration critical
- ▣ **Risk migration** to other parts of the financial system, including shadow banking entities
- ▣ **Resolvability versus diversification**

Extraterritorial impact on market liquidity



Diversification benefits?

Confidence Bands for Volatility-adjusted Return Ratios



Firm-specific structural measures

- ▣ Need for a targeted approach
 - “living wills” tailored to the risk profiles of individual banks at a global, group-level
- ▣ But this requires ability and willingness to supervise and resolve...
- ▣ ...and strong political support
- ▣ Development of principles to evaluate global implications
 - mitigate adverse implications by facilitating revisions
 - guidance for future measures contemplated by other jurisdictions

THANK YOU